

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

ANNUAL REPORT MAILING LABEL – MAKE CHANGES AS NECESSARY

<p>G-04204A UNS Gas, Inc. Attn: David Couture PO Box 711, MS UE201 Tucson, AZ 85702</p> <p>RECEIVED</p>	<p>U</p>
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ACC UTILITIES DIRECTOR

ANNUAL REPORT
Gas

FOR YEAR ENDING

12	31	2009
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FOR COMMISSION USE

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4-26-10

COMPANY INFORMATION

Company Name (Business Name) UNS Gas, Inc.

Mailing Address P.O. Box 711, Mail Stop UE-201

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

(520) 884-3752

Telephone No. (Include Area Code)

(520) 884-3601

Fax No. (Include Area Code)

N/A

Cell No. (Include Area Code)

Email Address dcouture@tep.com

Local Office Mailing Address P.O. Box 711, Mail Stop UE-201

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

(520) 884-3752

Local Office Telephone No. (Include Area Code)

(520) 884-3601

Fax No. (Include Area Code)

N/A

Cell No. (Include Area Code)

Email Address dcouture@tep.com

MANAGEMENT INFORMATION

☐ **Regulatory Contact:**

☐ **Management Contact:** David Couture

(Name)

Director of Government Relations

(Title)

P.O. Box 711, Mail Stop UE-201

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

(520) 884-3752

Telephone No. (Include Area Code)

(520) 884-3601

Fax No. (Include Area Code)

N/A

Cell No. (Include Area Code)

Email Address dcouture@tep.com

On Site Manager: Nathan Shelley

(Name)

General Manager Gas Operations

2901 W. Shamrell Blvd., Suite 110

(Street)

Flagstaff

(City)

Arizona

(State)

86001

(Zip)

(928) 226-2266

Telephone No. (Include Area Code)

(928) 779-5338

Fax No. (Include Area Code)

N/A

Cell No. (Include Area Code)

Email Address: nshelley@uesaz.com

Statutory Agent: Diana Durako

P.O. Box 711, Mail Stop UE-201 (Street)	(Name) Tucson (City)	Arizona (State)	85702 (Zip)
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(520) 571-4000 ext. 3652 Telephone No. (Include Area Code)	(520) 884-3601 Fax No. (Include Area Code)	N/A Cell No. (Include Area Code)
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Attorney: Raymond Heyman

P.O. Box 711, Mail Stop UE-183 (Street)	(Name) Tucson (City)	AZ (State)	85702 (Zip)
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(520) 571-4000 Telephone No. (Include Area Code)	(520) 884-3612 Fax No. (Include Area Code)	N/A Cell No. (Include Area Code)
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Email Address rheyman@tep.com

OWNERSHIP INFORMATION

Check the following box that applies to your company:

- | | |
|---|--|
| <input type="checkbox"/> Sole Proprietor (S) | <input checked="" type="checkbox"/> C Corporation (C) (Other than Association/Co-op) |
| <input type="checkbox"/> Partnership (P) | <input type="checkbox"/> Subchapter S Corporation (Z) |
| <input type="checkbox"/> Bankruptcy (B) | <input type="checkbox"/> Association/Co-op (A) |
| <input type="checkbox"/> Receivership (R) | <input type="checkbox"/> Limited Liability Company |
| <input type="checkbox"/> Other (Describe) _____ | |

COUNTIES SERVED

Check the box below for the county/ies in which you are certificated to provide service:

- | | | |
|--|---|--|
| <input checked="" type="checkbox"/> APACHE | <input type="checkbox"/> COCHISE | <input checked="" type="checkbox"/> COCONINO |
| <input type="checkbox"/> GILA | <input type="checkbox"/> GRAHAM | <input type="checkbox"/> GREENLEE |
| <input type="checkbox"/> LA PAZ | <input type="checkbox"/> MARICOPA | <input checked="" type="checkbox"/> MOHAVE |
| <input checked="" type="checkbox"/> NAVAJO | <input type="checkbox"/> PIMA | <input type="checkbox"/> PINAL |
| <input checked="" type="checkbox"/> SANTA CRUZ | <input checked="" type="checkbox"/> YAVAPAI | <input type="checkbox"/> YUMA |
| <input type="checkbox"/> STATEWIDE | | |

SERVICES AUTHORIZED TO PROVIDE

Check the following box(es) for the services that you are authorized to provide:

☒ **Gas**

☒ Natural Gas

☐ Propane

☐ **Other** (Specify) _____

STATISTICAL INFORMATION

Total number of customers (at 12/31/2009)	146,247	
Residential	133,679	
Commercial	11,430	
Industrial	23	
Public Authority	1,091	
Irrigation	6	
Negotiated Sales Program	18	
 Total therms sold	137,639,620	therms
Residential	69,640,536	
Commercial	29,574,282	
Industrial	2,103,914	
Public Authority	6,521,965	
Irrigation	47,788	
Negotiated Sales Program	29,751,135	

COMPANY NAME: UNS Gas, Inc.

UTILITY SHUTOFFS / DISCONNECTS

MONTH		Termination without Notice R14-2-311.B	Termination with Notice R14-2-311.C	OTHER
JANUARY			665	
FEBRUARY			355	
MARCH			775	
APRIL			878	
MAY			583	
JUNE			684	
JULY			404	
AUGUST			407	
SEPTEMBER			290	
OCTOBER			452	
NOVEMBER			330	
DECEMBER			190	
TOTALS →			6,013	

OTHER (description):

**VERIFICATION
AND
SWORN STATEMENT
Intrastate Revenues Only**

RECEIVED

ACC UTILITIES DIRECTOR

VERIFICATION

STATE OF Arizona

**I, THE UNDERSIGNED
OF THE**

COUNTY OF (COUNTY NAME)
Pima
NAME (OWNER OR OFFICIAL) TITLE
Karen G. Kissinger
COMPANY NAME
UNS Gas, Inc.

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2009

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENT OF TITLE 40, ARTICLE 8, SECTION 40-401, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS DURING CALENDAR YEAR 2009 WAS:

Arizona Intrastate Gross Operating Revenues Only (\$)

\$ 161,480,896

**(THE AMOUNT IN BOX ABOVE
INCLUDES \$ 14,005,957
IN SALES TAXES BILLED, OR COLLECTED)**

****REVENUE REPORTED ON THIS PAGE MUST
INCLUDE SALES TAXES BILLED OR
COLLECTED. IF FOR ANY OTHER REASON,
THE REVENUE REPORTED ABOVE DOES NOT
AGREE WITH TOTAL OPERATING REVENUES
ELSEWHERE REPORTED, ATTACH THOSE
STATEMENTS THAT RECONCILE THE
DIFFERENCE. (EXPLAIN IN DETAIL)**

Karen G. Kissinger
SIGNATURE OF OWNER OR OFFICIAL

TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

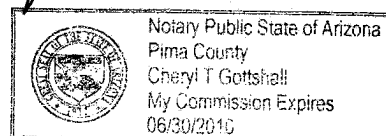
A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS 15th **DAY OF**
(SEAL)

COUNTY NAME		
Pima		
MONTH	April	2010

Cheryl T. Gottshall
SIGNATURE OF NOTARY PUBLIC

MY COMMISSION EXPIRES 06/30/2010



**VERIFICATION
AND
SWORN STATEMENT
RESIDENTIAL REVENUE
INTRASTATE REVENUES ONLY**

RECEIVED

ACC UTILITIES DIRECTOR

STATE OF ARIZONA

I, THE UNDERSIGNED

OF THE

COUNTY OF (COUNTY NAME) Pima	
NAME (OWNER OR OFFICIAL) Karen G. Kissinger	TITLE VP, Contr. & Chief Comp. Officer
COMPANY NAME UNS Gas, Inc.	

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH	DAY	YEAR
12	31	2009

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENTS OF TITLE 40, ARTICLE 8, SECTION 40-401.01, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS RECEIVED FROM RESIDENTIAL CUSTOMERS DURING CALENDAR YEAR 2009 WAS:

ARIZONA INTRASTATE GROSS OPERATING REVENUES

\$ 97,803,225

(THE AMOUNT IN BOX AT LEFT

INCLUDES \$ 8,482,909

IN SALES TAXES BILLED, OR COLLECTED

*RESIDENTIAL REVENUE REPORTED ON THIS PAGE
MUST INCLUDE SALES TAXES BILLED.

Karen G. Kissinger
SIGNATURE OF OWNER OR OFFICIAL

TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS

1st

DAY OF

(SEAL)

MY COMMISSION EXPIRES

06/30/2010

NOTARY PUBLIC NAME Cheryl T. Gottshall	
COUNTY NAME Pima	
MONTH April	2010



FINANCIAL INFORMATION

Attach to this annual report a copy of the companies' year-end (Calendar Year 2009) financial statements. If you do not compile these reports, the Utilities Division will supply you with blank financial statements for completion and filing. **ALL INFORMATION MUST BE ARIZONA-SPECIFIC AND REFLECT OPERATING RESULTS IN ARIZONA.**

UNS Gas, Inc.
Financial Statements
Years Ended December 31, 2009 and 2008



Report of Independent Auditors

To the Board of Directors and Stockholder of
UNS Gas, Inc.

In our opinion, the accompanying balance sheets and statements of capitalization and the related statements of income, cash flows, changes in stockholder's equity and comprehensive income present fairly, in all material respects, the financial position of UNS Gas, Inc. (the "Company") at December 31, 2009 and December 31, 2008, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
April 5, 2010

UNS GAS, INC.
STATEMENTS OF INCOME

	Years Ended December 31,	
	2009	2008
	- Thousands of Dollars -	
Operating Revenues		
Gas Revenue	\$ 149,385	\$ 171,908
Other Revenues	3,602	2,333
Total Operating Revenues	152,987	174,241
Operating Expenses		
Purchased Energy	93,528	126,647
Increase (Decrease) to Reflect PGA Recovery Treatment	5,367	(8,230)
Total Purchased Energy	98,895	118,417
Other Operations and Maintenance	25,377	25,389
Depreciation and Amortization	7,303	6,869
Taxes Other than Income Taxes	2,943	2,898
Total Operating Expenses	134,518	153,573
Operating Income	18,469	20,668
Other Income (Deductions)		
Interest Income	46	263
Other	(32)	(113)
Total Other Income	14	150
Interest Expense		
Long-Term Debt	6,395	6,426
Other Interest Expense	144	171
Interest Capitalized	(135)	43
Total Interest Expense	6,404	6,640
Income Before Income Taxes	12,079	14,178
Income Tax Expense	4,712	5,640
Net Income	\$ 7,367	\$ 8,538

See Notes to Financial Statements.

UNS GAS, INC.
STATEMENTS OF CASH FLOWS

	Years Ended December 31,	
	2009	2008
	- Thousands of Dollars -	
Cash Flows from Operating Activities		
Cash Receipts from Gas Retail Sales	\$ 168,972	\$ 189,040
Performance Deposit Receipts	7,750	-
Customer Deposits Received	2,093	1,951
Income Tax Refunds Received	806	638
Cash Receipts from Gas Wholesale Sales	708	-
Interest Received	90	247
Other Cash Receipts	414	-
Purchased Energy Costs Paid	(92,578)	(130,601)
Taxes Paid, Net of Amounts Capitalized	(17,592)	(18,221)
Payment of Other Operations and Maintenance Costs	(8,193)	(8,533)
Payment of Affiliate Charges	(8,104)	(8,528)
Wages Paid, Net of Amounts Capitalized	(7,111)	(7,092)
Interest Paid, Net of Amounts Capitalized	(6,208)	(6,272)
Performance Deposit Payments	(2,000)	(7,500)
Income Taxes Paid	(1,139)	(1,500)
Other Cash Payments	(953)	(782)
Net Cash Flows - Operating Activities	36,955	2,847
Cash Flows from Investing Activities		
Capital Expenditures	(13,378)	(16,488)
Net Cash Flows - Investing Activities	(13,378)	(16,488)
Cash Flows from Financing Activities		
Customer Advance Receipts	905	3,017
Customer Advance Refunds	(730)	(1,533)
Net Cash Flows - Financing Activities	175	1,484
Net Increase (Decrease) in Cash and Cash Equivalents	23,752	(12,157)
Cash and Cash Equivalents, Beginning of Period	7,148	19,305
Cash and Cash Equivalents, End of Period	\$ 30,900	\$ 7,148

See Notes to Financial Statements.

UNS ELECTRIC, INC.
BALANCE SHEETS

	December 31,	
	2009	2008
	- Thousands of Dollars -	
ASSETS		
Utility Plant		
Plant in Service	\$ 248,344	\$ 223,098
Utility Plant under Capital Leases	706	706
Construction Work in Progress	19,493	18,758
Total Utility Plant	268,543	242,562
Less Accumulated Depreciation and Amortization	(52,509)	(39,126)
Less Accumulated Amortization of Capital Lease Assets	(584)	(492)
Total Utility Plant - Net	215,450	202,944
Investments and Other Property	521	521
Current Assets		
Cash and Cash Equivalents	10,191	8,806
Accounts Receivable - Retail and Other	8,841	11,664
Unbilled Accounts Receivable	6,348	9,992
Accounts Receivable - Wholesale	112	115
Allowance for Doubtful Accounts	(995)	(1,379)
Accounts Receivable - Due from Affiliates	1,308	4,912
Income Tax Receivable	-	108
Materials and Supplies	9,633	8,984
Regulatory Assets - Derivative Instruments	9,268	16,571
Energy Contracts - Derivative Instruments	1,539	1,585
Deferred Income Taxes - Current	882	704
Regulatory Assets - Other	230	260
Collateral Posted for Derivative Contracts	-	6,620
Other	805	1,005
Total Current Assets	48,162	69,947
Other Assets		
Energy Contracts - Derivative Instruments	3,315	1,517
Regulatory Assets - Derivative Instruments	2,344	7,214
Regulatory Assets - Pension and Other Postretirement Benefits	1,918	2,575
Unamortized Debt Discount and Expense	625	728
Regulatory Assets - Other	442	243
Preliminary Engineering	418	368
Other	16	4
Total Other Assets	9,078	12,649
Total Assets	\$ 273,211	\$ 286,061

See Notes to Financial Statements.

(Balance Sheets Continued)

UNS GAS, INC.
BALANCE SHEETS

	December 31,	
	2009	2008
	- Thousands of Dollars -	
CAPITALIZATION AND OTHER LIABILITIES		
Capitalization		
Common Stock Equity	\$ 103,982	\$ 96,684
Long-Term Debt	100,000	100,000
Total Capitalization	203,982	196,684
Current Liabilities		
Accounts Payable - Purchased Energy	15,936	14,787
Accounts Payable	1,095	1,208
Accounts Payable - Due to Affiliates	1,714	2,345
Regulatory Liability - Over-Recovered Purchased Energy Costs	10,305	4,896
Energy Contracts - Derivative Instruments	5,044	7,790
Accrued Taxes Other than Income Taxes	4,633	4,940
Customer Deposits	2,938	2,687
Interest Accrued	2,385	2,378
Accrued Employee Expenses	1,570	1,278
Income Taxes Payable	-	87
Other	145	130
Total Current Liabilities	45,765	42,526
Deferred Credits and Other Liabilities		
Regulatory Liability - Net Cost of Removal for Interim Retirements	20,443	19,211
Deferred Income Taxes	19,266	14,107
Customer Advances for Construction	11,819	11,894
Deferred Employee Benefits	3,445	4,061
Energy Contracts - Derivative Instruments	2,635	5,739
Other	39	24
Total Deferred Credits and Other Liabilities	57,647	55,036
Total Capitalization and Liabilities	\$ 307,394	\$ 294,246

See Notes to Financial Statements.

(Balance Sheets Concluded)

UNS GAS, INC.
STATEMENTS OF CAPITALIZATION

			December 31,	
			2009	2008
			- Thousands of Dollars -	
COMMON STOCK EQUITY				
Common Stock—No Par Value			\$ 67,978	\$ 67,978
	2009	2008		
Shares Authorized	1,000	1,000		
Shares Outstanding	1,000	1,000		
Accumulated Earnings			36,004	28,706
Total Common Stock Equity			103,982	96,684
LONG-TERM DEBT				
Issue	Maturity	Interest Rate		
Senior Unsecured Notes - Series A	8/11/2011	6.23%	50,000	50,000
Senior Unsecured Notes - Series B	8/11/2015	6.23%	50,000	50,000
Total Long-Term Debt			100,000	100,000
Total Capitalization			\$ 203,982	\$ 196,684

See Notes to Financial Statements.

UNS GAS, INC.
STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY AND COMPREHENSIVE INCOME

	Common Shares Outstanding	Common Stock	Accumulated Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholder's Equity
- Thousands of Dollars -					
Balances at December 31, 2007	1,000	\$ 67,978	\$ 20,208	\$ 79	\$ 88,265
Impact of Change in Pension Plan Measurement Date	-	-	(40)	-	(40)
Comprehensive Income:					
2008 Net Income	-	-	8,538	-	8,538
Employee Benefit Obligations					
Amortization of net actuarial loss and prior service credit included in net periodic benefit cost (net of \$0 income taxes)	-	-	-	(1)	(1)
Reclassification of Postretirement Benefit to Regulatory Asset (net of \$19 income taxes)	-	-	-	(29)	(29)
Reclassification of Unrealized Gain on Cash Flow Hedges to Regulatory Asset (net of \$32 income taxes)	-	-	-	(49)	(49)
Total Comprehensive Income					8,459
Balances at December 31, 2008	1,000	\$ 67,978	\$ 28,706	\$ -	\$ 96,684
Impact of Prior Years' Adjustment - Stock Based Compensation	-	-	(69)	-	(69)
Comprehensive Income:					
2009 Net Income	-	-	7,367	-	7,367
Total Comprehensive Income					7,367
Balances at December 31, 2009	1,000	\$ 67,978	\$ 36,004	\$ -	\$ 103,982

See Notes to Financial Statements.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE 1. NATURE OF OPERATIONS

UNS Gas, Inc. (UNS Gas) is a gas distribution company serving approximately 146,000 retail customers in Mohave, Yavapai, Coconino, and Navajo Counties in Northern Arizona, as well as Santa Cruz County in Southeast Arizona. UniSource Energy Services, Inc. (UES), an intermediate holding company, owns all of the common stock of UNS Gas and UNS Electric, Inc. UniSource Energy Corporation (UniSource Energy) owns all of the common stock of UES.

References to “we” and “our” are to UNS Gas.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

UNS Gas’ accounting policies conform to accounting principles generally accepted in the United States of America (GAAP), including the accounting principles for rate-regulated enterprises.

USE OF ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

ACCOUNTING FOR RATE REGULATION

The Arizona Corporation Commission (ACC) regulates portions of UNS Gas’ utility accounting practices and gas rates. The ACC has authority over certain rates charged to retail customers, the issuance of securities, and transactions with affiliated parties. UNS Gas is generally not subject to Federal Energy Regulatory Commission (FERC) jurisdiction as it is not an interstate pipeline.

UNS Gas generally uses the same accounting policies and practices used by unregulated companies. However, sometimes regulatory accounting requires rate-regulated companies to apply special accounting treatment to show the effect of rate-regulation. For example, the ACC can determine that UNS Gas is allowed to recover certain expenses, but at a designated time in the future. In this situation, UNS Gas defers these items and shows them as regulatory assets on the balance sheet until it is allowed to charge its customers. UNS Gas then amortizes these items as expenses as it recovers these charges from customers. Similarly, certain revenue items may be deferred as regulatory liabilities, which are also eventually amortized to the income statement as rates to customers are reduced. We evaluate our regulatory assets each period and believe recovery is probable.

The conditions a rate-regulated company must satisfy to apply regulatory accounting policies and practices include:

- An independent regulator sets rates;
- The regulator sets the rates to recover the specific enterprise’s costs of providing service; and
- The service territory lacks competitive pressures to reduce rates below the rates set by the regulator. See Note 3.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

CASH AND CASH EQUIVALENTS

UNS Gas defines Cash and Cash Equivalents as cash (unrestricted demand deposits) and all highly liquid investments purchased with an original maturity of three months or less.

UTILITY PLANT

UNS Gas reports utility plant at cost. Utility plant includes material and labor costs, contractor services, construction overhead costs (where applicable), and an Allowance for Funds Used During Construction (AFUDC). UNS Gas charges maintenance and repairs to operating expense as incurred.

AFUDC, which reflects the cost of debt or equity funds used to finance construction, is capitalized as part of the cost of regulated utility plant. AFUDC applies to all regulated operations that follow regulatory accounting. AFUDC amounts capitalized are included in rate base for establishing utility rates. UNS Gas recovers AFUDC in rates through depreciation expense over the useful life of the related asset. UNS Gas imputed the cost of capital on construction expenditures at an average of 7.05% for 2009 and 8.37% for 2008. The component of AFUDC attributable to borrowed funds is shown as Interest Capitalized, a reduction of Interest Expense, on the income statement and totaled \$0.1 million in 2009 and 2008, respectively. The equity component is included in Other Income and totaled \$0.1 million in both 2009 and 2008.

UNS Gas computes depreciation of utility plant on a straight-line basis over the service lives of the assets. The average annual depreciation rates for UNS Gas' utility plant were 2.76% in 2009 and 2.77% in 2008.

MATERIALS AND SUPPLIES

UNS Gas carries materials and supplies in inventory at the lower of average cost or market.

COMPUTER SOFTWARE COSTS

UNS Gas capitalizes costs incurred to purchase and develop computer software for internal use and amortizes those costs over the estimated economic life of the product. UNS Gas immediately expenses capitalized computer software costs if the software is determined to be no longer useful.

DEFERRED FINANCING COSTS

UNS Gas defers costs related to the issuance of debt. These costs include underwriters' commissions, discounts or premiums, and other costs such as legal, accounting and regulatory fees and printing costs. UNS Gas amortizes the costs over the life of the debt using the straight-line method, which approximates the effective interest method. Unamortized debt issuance costs are shown as Unamortized Debt Discount and Expense on the balance sheet. See Note 5.

UTILITY OPERATING REVENUES

UNS Gas records utility operating revenues when services are provided or commodities are delivered to customers. Operating revenues include unbilled revenues which are earned (service has been provided) but not billed by the end of an accounting period.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

Amounts delivered are determined through systematic monthly readings of customer meters. At the end of the month, the usage since the last meter reading is estimated and the corresponding unbilled revenue is calculated. Unbilled revenue is calculated based on daily purchased volumes, estimated customer usage by class, estimated line losses and estimated average customer rates. Accrued unbilled revenues are reversed the following month when actual billings occur. The accuracy of the unbilled revenue estimate is affected by factors that include fluctuations in energy demands, weather, line losses, and changes in the composition of customer classes.

UNS Gas has a rate-adjustment mechanism in place that allows for a revenue surcharge or surcredit (that adjusts the customer's base rate for delivered gas) to collect or return under- or over- recovery of costs. This rate-adjustment mechanism is revised periodically and may increase or decrease the level of costs recovered through retail rates for any difference between the total amount collected under the clause and the recoverable costs incurred. See Note 3.

UNS Gas records an Allowance for Doubtful Accounts to reduce accounts receivable for revenue amounts that are estimated to be uncollectible. UNS Gas establishes an allowance for doubtful accounts based on historical experience and any specific customer collection issues that are identified.

Other Revenues primarily consist of miscellaneous fees, including service connection and late fees, and revenue from transportation of gas that customers purchase from other providers.

PURCHASED GAS COSTS

UNS Gas defers differences between gas purchase costs and the recovery of such costs in base rates under a Purchased Gas Adjustor (PGA) mechanism. The PGA mechanism addresses the volatility of natural gas prices and allows UNS Gas to recover its commodity costs through a price adjustor. The PGA factor, computed monthly, is a calculation of the twelve-month rolling weighted average gas cost, and automatically adjusts monthly, subject to limitations on how much the price per therm may change in a twelve-month period. The difference between the actual cost of UNS Gas' gas supplies and transportation contracts and that cost which is currently allowed by the ACC is deferred and recovered or repaid through the PGA mechanism. When under or over recovery trigger points are met, UNS Gas may request a PGA surcharge or surcredit with the goal of collecting or returning the amount deferred from or to customers over a twelve-month period. See Note 3.

RELATED PARTY TRANSACTIONS

UNS Gas receives certain corporate and administrative support services from affiliates. These costs consist primarily of employee compensation and benefits. Tucson Electric Power Company (TEP), a regulated public utility serving retail electric customers in Southern Arizona, is UniSource Energy's largest operating subsidiary. Services from TEP totaled \$7 million in 2009 and in 2008. Services from UNS Electric totaled \$0.6 million in 2009 and \$0.5 million in 2008. Southwest Energy Solutions, Inc., another UniSource Energy affiliate, charged UNS Gas \$0.1 million in 2009 and 2008 for meter reading services.

In 2008, UED entered into a gas supply and transportation agreement with UNS Gas. UED assigned this agreement to UNS Electric in May 2008. UNS Gas charged UNS Electric \$5 million for gas used by BMGS in 2009 and \$7 million in 2008. In 2008, UNS Gas charged UED \$1 million for gas used by the BMGS facility.

Balances arising from transactions with affiliates are recorded on the balance sheets as Accounts Receivable – Due from Affiliates or Accounts Payable – Due to Affiliates.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

INCOME TAXES

GAAP requires us to report some of our assets and liabilities differently for our financial statements than we do for income tax purposes. We reflect the tax effects of these differences as deferred income tax assets or liabilities in our balance sheets. We measure these deferred tax assets and liabilities using current income tax rates. Federal and state income tax credits are accounted for as a reduction of income tax expense in the year in which the credit arises.

Tax benefits are recognized in the financial statements when it is more likely than not that a tax position will be sustained upon examination by the tax authorities based on the technical merits of the position. The tax benefit recorded is the largest amount that is more than 50% likely to be realized upon ultimate settlement with the tax authority. In calculating the benefit to be recognized we assume the tax authorities have full knowledge of the position and all relevant facts. Interest Expense includes interest accrued by UNS Gas on tax positions taken on tax returns which have not been reflected in the financial statements.

UNS Gas is a member of the UniSource Energy consolidated income tax filing. UNS Gas is allocated income taxes based on its taxable income and deductions as reported in the UniSource Energy consolidated and/or combined tax return filings. The tax liability is allocated in accordance with the income tax regulations. As a result, the regular and AMT tax liability of UNS Gas is calculated on a stand alone basis and the liability is then owed to UniSource Energy through intercompany accounts. UniSource Energy has the ultimate responsibility for payment of consolidated tax liabilities to taxing authorities and maintaining intercompany tax accounts with its subsidiaries.

TAXES OTHER THAN INCOME TAXES

UNS Gas acts as a conduit or collection agent for excise tax (sales tax) as well as franchise fees and regulatory assessments. UNS Gas records liabilities payable to governmental agencies when it charges its customers for these amounts. Neither the amounts charged nor payable are reflected in the income statement.

DERIVATIVE FINANCIAL INSTRUMENTS

UNS Gas is exposed to energy price risk associated with its gas requirements, volumetric risk associated with its seasonal load and operational risk associated with its transportation systems. The energy price risk is mitigated through the PGA mechanism which provides an adjustment to UNS Gas' retail rates to recover the actual costs of gas and transportation. UNS Gas further reduces its energy price risk through a variety of derivative and non-derivative instruments. The objectives for entering into such contracts include: creating price stability for UNS Gas; to ensure UNS Gas can meet its load and reserve requirements; and reducing UNS Gas' exposure to price volatility that may result from delayed recovery under the PGA. See Note 3 for further information regarding regulatory matters.

UNS Gas considers the effect of counterparty credit risk in determining the fair value of derivative instruments that are in a net asset position, after incorporating collateral posted by counterparties, and allocate the credit risk adjustment to individual contracts. UNS Gas also considers the impact of its own credit risk, after considering collateral posted, on instruments that are in a net liability position and allocate the credit risk adjustment to all individual contracts.

UNS Gas presents cash collateral and derivative assets and liabilities, associated with the same counterparty, separately in its financial statements and bifurcates all derivatives into their current and long-term portions on the balance sheet.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

Cash Flow Hedges

UNS Gas has no cash flow hedges.

Mark-to-Market

UNS Gas enters into derivatives such as forward gas purchases and gas swaps, creating price stability and reducing exposure to natural gas price volatility that may result in delayed recovery under the PGA. Beginning in December 2008, unrealized gains and losses are recorded as either a regulatory asset or regulatory liability, as the UNS Gas PGA mechanism permits the recovery of the prudent cost of hedging contracts.

Normal Purchase and Normal Sale

UNS Gas enters into forward gas purchases, based on forecasted needs, with counterparties that can supply its physical gas requirements. These contracts meet the normal purchase scope exception and are not required to be marked to market. On an ongoing basis, we evaluate our counterparties for non-performance risk to ensure such risk does not impact our ability to obtain the normal scope exception.

2008 Accounting Summary

Prior to December 2008, UNS Gas recorded unrealized gains and losses on derivative instruments as follows:

- UNS Gas' forward gas swaps were recorded in AOCI;
- All other commodity contracts were reflected on the balance sheet as either regulatory assets or regulatory liabilities.

FAIR VALUE OF FINANCIAL INSTRUMENTS NOT CARRIED AT FAIR VALUE

The fair value of a financial instrument is the market price that would be received to sell an asset or transfer a liability at the measurement date.

UNS Gas' senior unsecured notes of \$100 million outstanding at December 31, 2009 and December 31, 2008, have estimated fair values of \$105 million and \$100 million, respectively. UNS Gas used quoted market prices, where available, or calculated the present value of remaining cash flows at the balance sheet date using current market rates for bonds with similar characteristics with respect to credit rating and time-to-maturity. UNS Gas also incorporates the impact of its own credit risk using a credit default swap rate when determining the fair value of fixed rate long-term debt.

The use of different market assumptions and/or estimation methodologies may yield different estimated fair value amounts.

EVALUATION OF ASSETS FOR IMPAIRMENT

UNS Gas evaluates its Utility Plant and other long-lived assets for impairment whenever events or circumstances occur that may indicate the carrying value of the assets may be impaired. If the fair value of the asset, determined based on the undiscounted expected future cash flows, is less than the carrying value of the asset, an impairment charge would be recorded.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

ASSET RETIREMENT OBLIGATIONS

UNS Gas does not currently have any asset retirement obligations.

UNS Gas records cost of removal for its transport and distribution assets through depreciation rates and recovers those amounts in rates charged to its customers. There are no legal obligations associated with these assets. UNS Gas records its obligation for estimated costs of removal as regulatory liabilities.

COMPREHENSIVE INCOME

UNS Gas had no elements of Accumulated Other Comprehensive Income (AOCI) in 2009. Prior to December 2008, UNS Gas recorded unrealized gains and losses on forward gas swaps in AOCI. Beginning in December 2008, unrealized gains and losses are recorded as either a regulatory asset or regulatory liability, as the UNS Gas PGA mechanism permits the recovery of the prudent costs of hedging contracts. Beginning in 2008, UNS Gas records changes in its other postretirement obligation, not yet reflected in net periodic benefit cost, as a regulatory asset; as such amounts are probable of future recovery in rates. Amounts previously recorded in AOCI were reclassified to a regulatory asset in 2008.

SUBSEQUENT EVENTS

Effective June 2009, UNS Gas adopted a policy related to accounting for and disclosure of subsequent events that occur after the balance sheet date but before financial statements are issued. In accordance with this policy, UES evaluated subsequent events occurring through the issuance date in preparing these financial statements.

RECLASSIFICATIONS AND OTHER ADJUSTMENTS

Renewable Energy and Demand Side Management (DSM) Revenues

UNS Gas reclassified renewable revenue of \$0.4 million in 2008 from Other Revenue to Gas Revenue in the Statement of Income. This reclassification had no effect on income.

Dividend Equivalents

In September 2009, UNS Gas recorded dividends of less than \$0.1 million for dividend equivalents that should have been recorded between 2005 and 2008.

Purchased Energy

UNS Gas has a Purchased Gas Adjuster (PGA) mechanism which allows UNS Gas to recover its actual commodity costs, including transportation. See Note 3.

To provide more information regarding the components of the PGA and to be comparable with the 2009 presentation, UNS Gas made the following reclassification to the statement of income for the year ended December 31, 2008.

- UNS reclassified \$8.2 million in 2008 of over-recovered PGA expenses from Purchased Energy, Transmission, and Fuel to Increase (Decrease) to reflect PGA Recovery Treatment, a component of Total Fuel and Purchased Energy.

This reclassification had no effect on Net Income.

RECENTLY ISSUED ACCOUNTING STANDARDS

The following recently issued accounting standards are not yet reflected in the UNS Gas financial statements:

- The FASB issued authoritative guidance for transfers of financial assets that clarify and change the criteria for a transfer to be accounted for as a sale, change the amount of a recognized gain/loss on a sale when beneficial interests are received by the transferor, and requires extensive disclosures. This standard is effective for interim and annual periods beginning January 1, 2010. To date, we have not participated in any transfers to which this guidance is applicable.
- The FASB issued authoritative guidance for variable interest entities requiring an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. This standard did not have an impact on our financial statements on adoption on January 1, 2010.
- The FASB issued authoritative guidance for multiple deliverable revenue arrangements that provides another alternative for determining the selling price of deliverables and eliminates the residual method of allocating consideration. In addition, this pronouncement requires expanded qualitative and quantitative disclosures and is effective for revenue arrangements entered into after January 1, 2011. We are evaluating the impact of this pronouncement.
- The FASB issued amendments that require some new disclosures and clarify some existing disclosure requirements about fair value measurements. The amendments are effective for annual reporting periods beginning January 1, 2010, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in level 3 fair value measurements, which are effective for annual reporting periods beginning January 1, 2011. We are evaluating the impact of these new and revised disclosures on our financial statements.

NOTE 3. REGULATORY MATTERS

2008 General Rate Case Filing

In November 2008, UNS Gas filed a general rate case (on a cost of service basis) with the ACC requesting a total rate increase of 6% to cover a revenue deficiency of \$10 million. The case uses a June 30, 2008 test year. In March 2010, an ACC Administrative Law Judge issued a Recommended Order and Opinion (ROO) recommending a total rate increase of 2% effective April 1, 2010. UNS Gas filed an exception to the ROO. The ACC is still considering the exception filed and has not yet signed a final order.

Purchase Gas Adjustor (PGA) Mechanism

UNS Gas' retail rates include a PGA mechanism intended to address the volatility of natural gas prices and allow UNS Gas to recover its actual commodity costs, including transportation, through a price adjustor. All purchased gas commodity costs, including transportation, increase the PGA bank, a balancing account. UNS Gas recovers these costs or returns amounts over-collected from/to ratepayers through a PGA rate. The PGA rate includes the following two components:

- (1) The **PGA factor**, computed monthly, is a calculation of the twelve-month rolling weighted average gas cost, and automatically adjusts monthly, subject to limitations on how much the price per

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

therm may change in a twelve-month period. The maximum increase in the PGA factor is 15 cents per therm in a twelve-month period.

- (2) At any time UNS Gas' PGA bank balance is under-recovered, UNS Gas may request a **PGA surcharge** with the goal of collecting the amount deferred from customers over a period deemed appropriate by the ACC. When the PGA bank balance reaches an over-collected balance of \$10 million on a billed basis, UNS Gas is required to request a **PGA surcredit** with the goal of returning the over-collected balance to customers over a period deemed appropriate by the ACC.

The PGA surcredit was 4 cents per therm from October 2007 through April 2008. From May 2008 through October 2009, there was no surcharge or surcredit in effect. In October 2009, the ACC approved an 8 cent per therm PGA surcredit, effective November 2009 through October 2010 or until the balance reaches zero.

Based on current projections of gas prices, UNS Gas believes that the current PGA rates will allow it to timely recover its gas costs. However, changes in the market price for gas, sales volumes and surcharges could significantly change the PGA bank balance in the future.

The following table shows the balance of Over-Recovered Purchased Gas costs:

	December 31,	
	2009	2008
	-Thousands of Dollars-	
(Over) Under Recovered Purchased Gas Costs – Regulatory Basis as Billed to Customers	\$ (2,431)	\$ 4,822
Estimated Purchased Gas Costs Recovered through Accrued Unbilled Revenues	(7,874)	(9,716)
Over-Recovered Purchased Gas Costs (PGA) Included as a Current Regulatory Liability	\$ (10,305)	\$ (4,896)

Other Regulatory Assets and Liabilities

In addition to Over-Recovered Purchased Gas costs, UNS Gas has the following Regulatory Assets and Liabilities:

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Current Assets		
Derivative Instruments	\$ 4,878	\$ 7,463
Self-Insured Medical and Short-Term Disability Assets	290	160
Demand-Side Management (DSM) Assets	81	45
Other Regulatory Assets		
Pension Obligations	2,062	2,864
Derivative Instruments	2,527	5,711
Low Income Assistance Program	493	493
Rate Case Costs	391	480
Other Regulatory Liabilities		
Net Cost of Removal for Interim Retirements	(20,443)	(19,211)
Other Regulatory Liabilities	(11)	(23)

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

Regulatory assets are either being collected in rates or are expected to be collected through rates in a future period, as described below:

- Derivative instruments represent the unrealized gains or losses on contracts entered into to hedge the variability of purchased energy costs that are expected to be recovered through the PGA. UNS Gas does not earn a return on these costs.
- Self-Insured Medical and Short-Term Disability assets are recorded based on historical ratemaking treatment allowing UNS Gas to recover self-insured medical costs and short-term disability costs on a pay-as-you-go or cash basis. While these assets do not earn a return, they are fully recovered in rates over an approximate one-year period.
- The ACC has approved a DSM adjustor surcharge that allows UNS Gas to recover the prudent costs of Commission-approved DSM programs. Any DSM surcharges billed in excess of qualified DSM expenditures should be reflected as a deferred liability. Conversely, qualified expenditures in excess of amounts collected through the DSM adjustor rate should be recorded as a DSM regulatory asset. UNS Gas does not earn a return on these costs.
- Pension assets represent the unfunded status of UNS Gas' share of the UES pension and other postretirement benefit plans that it expects, based on past regulatory actions, to recover through rates. UNS Gas does not earn a return on these costs.
- UNS Gas requested recovery of costs related to its low income assistance program in the rate case filed in November 2008. The recommended recovery period in the ROO is 3 years.
- Rate Case costs are deferred based on past recovery over 3 years. The recommended recovery period in the ROO is 3 years. UNS Gas does not earn a return on these costs.

Regulatory liabilities represent items that UNS Gas expects to pay to customers through billing reductions in future periods or use for the purpose for which they were collected from customers, as described below:

- Net cost of Removal for Interim Retirements represents an estimate of the cost of future asset retirement obligations. These are amounts collected through revenue for the net cost of removal of interim retirements for which removal costs have not yet been expended.

Income Statement Impact of Applying Regulatory Accounting

If UNS Gas had not applied regulatory accounting, net income would have been \$6 million higher in 2009, as UNS Gas would have been able to recognize over-recovered purchased energy costs and unrealized gains on its commodity derivative instruments as a credit to its expenses in the income statement rather than record a regulatory liability. Net income would have been \$4 million lower in 2008 as UNS Gas would have recognized under-recovered purchased energy costs and unrealized losses on its commodity derivative instruments as an expense to its income statement rather than a reduction to its regulatory liability.

Future Implications of Discontinuing Application of Regulatory Accounting

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

UNS Gas regularly assesses whether it can continue to apply regulatory accounting. If UNS Gas stopped applying regulatory accounting to its regulated operations, regulatory pension assets would be reflected in AOCI and UNS Gas would write-off the remaining related balance of its regulatory assets as an expense and write-off its regulatory liabilities as income on its income statement. Based on the regulatory asset and liability balances, if UNS Gas had stopped applying regulatory accounting to its regulated operations, it would have recorded an extraordinary after-tax gain of \$13 million and an after-tax loss in AOCI of \$1 million at December 31, 2009. Discontinuing application of regulatory accounting would not affect UNS Gas cash flows.

NOTE 4. UTILITY PLANT

The following table shows Utility Plant in Service and depreciable lives by major class at December 31:

	2009	2008	Depreciable Lives
	-Thousands of Dollars-		
Plant in Service:			
Gas Distribution Plant	\$ 215,873	\$ 200,947	30 – 55 years
Gas Transmission Plant	17,554	17,554	30 – 65 years
General Plant	15,464	14,486	5 – 35 years
Intangible Plant	827	827	15 – 25 years
Computer Software	32	32	3 years
Total Plant in Service	\$ 249,750	\$ 233,846	

Intangible Plant is principally comprised of franchises and consents.

NOTE 5. DEBT AND CREDIT FACILITIES

UNS GAS LONG-TERM DEBT

UNS Gas has \$100 million of senior unsecured notes outstanding, consisting of \$50 million at 6.23%, due August 2011, and \$50 million at 6.23%, due August 2015. The notes may be prepaid with a make-whole call premium reflecting a discount rate equal to an equivalent maturity U.S. Treasury security yield plus 50 basis points. UES guarantees the notes.

The UNS Gas note agreements contain certain restrictive covenants, including restrictions on transactions with affiliates, mergers, liens to secure indebtedness, dividends or distributions on common stock and incurrence of indebtedness. As of December 31, 2009, UNS Gas was in compliance with these covenants.

The table below outlines the actual and required minimum net worth levels of UES and UNS Gas, per the UNS Gas note agreements, at December 31, 2009.

	Required Minimum Net Worth	Actual Net Worth
	-Thousands of Dollars-	
UES	\$ 50,000	\$ 193,605
UNS Gas	43,000	103,982

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

The incurrence of indebtedness covenant requires UNS Gas to meet certain tests before additional indebtedness may be incurred. These tests include:

- A ratio of Consolidated Long-Term Debt to Consolidated Total Capitalization of no greater than 65%.
- An Interest Coverage Ratio (a measure of cash flow to cover interest expense) of at least 2.50 to 1.00.

However, UNS Gas may, without meeting these tests, refinance indebtedness and incur short-term debt in an amount not to exceed \$7 million. If UNS Gas complies with the terms of its note agreements, UNS Gas may pay dividends to UES.

The senior unsecured notes may be accelerated upon the occurrence and continuance of an event of default such as failure to make required payments, certain events of bankruptcy, reorganization proceedings or a change of control of UES or UNS Gas.

REVOLVING CREDIT AGREEMENT

The UNS Gas/UNS Electric Revolver is a \$60 million revolving credit facility which matures in August 2011. Either UNS Gas or UNS Electric may borrow up to a maximum of \$45 million, so long as the combined amount borrowed does not exceed \$60 million. UNS Gas is only liable for UNS Gas' borrowings, and similarly, UNS Electric is only liable for UNS Electric's borrowings under the UNS Gas/UNS Electric Revolver. The revolver may be used to issue letters of credit, as well as for revolver borrowings. UES guarantees the obligations of both UNS Gas and UNS Electric.

UNS Gas has the option of paying interest at LIBOR plus 1.0% or the greater of the federal funds rate plus 0.5% or the agent bank's reference rate.

The UNS Gas/UNS Electric Revolver contains restrictions on additional indebtedness, liens, dividends, mergers and sales of assets. The UNS Gas/UNS Electric Revolver also contains a maximum leverage ratio and a minimum cash flow to interest coverage ratio for each borrower. As of December 31, 2009, UNS Gas was in compliance with the terms of the UNS Gas/UNS Electric Revolver.

As of December 31, 2009 and December 31, 2008, UNS Gas had no borrowings outstanding under the UNS Gas/UNS Electric Revolver. At December 31, 2008, UNS Gas had \$10 million in outstanding letters of credit and none at December 31, 2009. The letters of credit issued support gas purchases and are off-balance sheet obligations for UNS Gas.

NOTE 6. COMMITMENTS AND CONTINGENCIES

UNS Gas records liabilities for loss contingencies, including environmental remediation costs, arising from claims, assessments, litigation, fines and penalties and other sources when it is probable that a liability has been incurred and the amount of the assessment can be reasonably estimated.

PURCHASE AND TRANSPORTATION COMMITMENTS

At December 31, 2009, UNS Gas had firm non-cancelable purchase commitments for fuel, including transportation, as follows:

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

	2010	2011	2012	2013	2014	Thereafter	Total
	-Thousands of Dollars-						
Fuel (including transportation	\$18,744	\$14,214	\$ 5,443	\$ 2,676	\$2,676	\$23,692	\$67,445

UNS Gas purchases gas from various suppliers at market prices. However, UNS Gas' risk of loss due to increased costs (as a result of changes in the market price of fuel) is mitigated through the use of the PGA, which provides for pass-through of most fuel costs to customers. UNS Gas' forward gas purchase agreements expire through 2012. Certain of these contracts are at a fixed price per mmbtu and others are indexed to natural gas prices. UNS Gas has firm transportation agreements with capacity sufficient to meet its load requirements. These contracts expire in various years between 2011 and 2024.

OPERATING LEASES

UNS Gas has entered into operating leases, primarily for office facilities and office equipment, with varying terms, provisions, and expiration dates. UNS Gas' estimated future minimum payments under non-cancelable operating leases at December 31, 2009 were:

	2010	2011	2012	2013	2014	Thereafter	Total
	-Thousands of Dollars-						
Operating Leases	\$ 527	\$ 533	\$ 358	\$ 341	\$ 354	\$ 844	\$ 2,957

UNS Gas' operating lease expense was \$0.5 million in 2009 and \$0.6 million in 2008.

GUARANTEES AND INDEMNITIES

UES guaranteed \$100 million of senior unsecured notes issued by UNS Gas and the \$60 million UNS Gas/UNS Electric Revolver. See Note 5. We believe that the likelihood UES would be required to perform or otherwise incur any significant losses associated with these guarantees is remote.

UniSource Energy has guaranteed \$1.5 million in building lease payments for UNS Gas.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

NOTE 7. INCOME AND OTHER TAXES

INCOME TAXES

We record deferred tax liabilities for amounts that will increase income taxes on future tax returns. We record deferred tax assets for amounts that could be used to reduce income taxes on future tax returns. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the entire deferred tax asset will not be realized. Management believes that based on the historical pattern of taxable income, UNS Gas will produce sufficient taxable income in the future to realize its deferred tax assets. As a result, no valuation allowance has been recorded on the deferred income tax assets for the years ended December 31, 2009 and December 31, 2008.

UniSource Energy includes UNS Gas' taxable income in its consolidated federal income tax return. Deferred tax assets (liabilities) consist of the following:

	December 31	
	2009	2008
	-Thousands of Dollars-	
Gross Deferred Income Tax Liabilities		
Plant	\$ (27,708)	\$ (21,798)
Other	(381)	(392)
Gross Deferred Income Tax Liabilities	(28,089)	(22,190)
Gross Deferred Income Tax Assets		
Customer Advances	4,966	5,007
Contributions in Aid of Construction	2,853	2,415
Compensation and Benefits	1,399	955
Other	200	230
Gross Deferred Income Tax Assets	9,418	8,607
Net Deferred Income Tax Liability	\$ (18,671)	\$ (13,583)

The net deferred income tax assets (liabilities) are included in the balance sheet in the following accounts:

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Deferred Income Taxes – Current Asset	\$ 595	\$ 524
Deferred Income Taxes – Noncurrent Liabilities	(19,266)	(14,107)
Net Deferred Income Tax Liability	\$(18,671)	\$(13,583)

Income tax expense included in the income statement includes amounts both payable currently and deferred for payment in future periods as indicated below:

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Current Tax Expense		
Federal	\$ (611)	\$ 1,712
State	292	171
Deferred Tax Expense		
Federal	4,538	3,247
State	493	510
Total Federal and State Income Tax Expense	\$ 4,712	\$ 5,640

The following reconciles the provision for income taxes at the federal statutory rate of 35% to the effective rate:

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Federal Income Tax Expense at Statutory Rate	\$ 4,228	\$ 4,962
State Income Tax Expense, Net of Federal Deduction	547	654
Other	(63)	24
Total Federal and State Income Tax Expense	\$ 4,712	\$ 5,640

UNS Gas net intercompany tax payable to affiliates equals \$.6 million at December 31, 2009. UNS Gas includes these amounts in intercompany accounts payable on the balance sheet.

Uncertain Tax Positions

Accounting guidance requires us to determine whether it is "more likely than not" that we will sustain a tax position under examination. Each uncertain tax position is measured to determine the amount of benefit to recognize in the financial statements.

At the end of 2009 and 2008, UNS Gas has no uncertain tax positions.

NOTE 8. PENSION AND POSTRETIREMENT BENEFIT PLANS

UNS Gas does not maintain a separate pension plan or other postretirement benefit plan for its employees. All regular employees are eligible to participate in the pension plan maintained by our parent, UES. A small group of active employees are also eligible to participate in a postretirement medical benefit plan. UES allocates net periodic benefit cost based on service cost for participating employees.

PENSION PLAN

The noncontributory, defined benefit pension plan (the Plan) provides benefits based on years of service and the employee's average compensation. UNS Gas recognizes its share of the underfunded status of the UES defined benefit pension plan as a liability on its balance sheets. The underfunded status is measured as the difference between the fair value of the plan's assets and the projected benefit obligation for pension plans. UNS Gas recognizes a regulatory asset to the extent these future costs are probable of recovery in rates.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

Pension Contributions

The Pension Protection Act of 2006 (The Pension Act) establishes minimum funding targets for pension plans beginning in 2008. A plan's funding target is the present value of all benefits accrued or earned as of the beginning of the plan year. While the annual targets are not legally required, if a plan does not meet the annual funding targets, the plan's benefit payment options are limited and a funding deficiency notice must be sent to all plan participants. The UES pension plan is in compliance with The Pension Act.

In 2010, UNS Gas expects to contribute \$0.8 million to the pension plan.

OTHER POSTRETIREMENT BENEFIT PLAN

UNS Gas assumed a \$0.8 million liability for postretirement medical benefits for current retirees and a small group of active employees at the acquisition of the Arizona gas system assets. The selected active employees participate in a Postretirement Benefit Plan covering employees of UniSource Energy. Beginning in 2008, UNS Gas records changes in its other postretirement obligation, not yet reflected in net periodic benefit cost, as a regulatory asset, as such amounts are probable of future recovery in rates. Amounts previously recorded in AOCI were reclassified to a regulatory asset in 2008.

The pension and other postretirement benefit related amounts (excluding tax balances) included in UNS Gas' balance sheet are:

	Pension Benefits		Other Postretirement Benefits	
	Years Ended December 31,			
	2009	2008	2009	2008
	-Thousands of Dollars-			
Regulatory Pension Asset included in Regulatory Assets	\$1,968	\$2,782	\$ 94	\$ 81
Accrued Benefit Liability included in Accrued Employee Expenses	-	-	(44)	(50)
Accrued Benefit Liability included in Deferred Employee Benefits	(2,918)	(3,533)	(487)	(489)
Net Amount Recognized	\$ (950)	\$ (751)	\$ (437)	\$ (458)

OBLIGATIONS AND FUNDED STATUS

UNS Gas measured the actuarial present values of all pension benefit obligations and other postretirement benefit plans at December 31, 2009 and December 31, 2008. The previous measurement date was December 1. As a result of the change in the measurement date, UNS Gas recorded a loss of less than \$0.1 million to retained earnings in January 2008.

The tables below reflect UES' plan information as a whole. The change in projected benefit obligation and plan assets and reconciliation of the funded status are as follows:

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

	Pension Benefits		Other Postretirement Benefits	
	Years Ended December 31,			
	2009	2008	2009	2008
	-Thousands of Dollars-			
Change in Projected Benefit Obligation				
Benefit Obligation at Beginning of Year	\$10,485	\$ 7,352	\$ 1,194	\$ 1,154
Actuarial (Gain) Loss	(168)	1,833	34	277
Interest Cost	651	501	73	77
Service Cost	1,101	917	-	-
Measurement Date Change	-	118	-	-
Benefits Paid	(625)	(236)	(158)	(314)
Projected Benefit Obligation at End of Year	11,444	10,485	1,143	1,194
Change in Plan Assets				
Fair Value of Plan Assets at Beginning of Year	3,937	4,889	-	-
Actual Return on Plan Assets	1,241	(1,951)	-	-
Benefits Paid	(625)	(236)	(198)	(362)
Employer Contributions	1,588	1,200	165	314
Participant Contributions	-	-	40	48
Measurement Date Change	-	35	-	-
Fair Value of Plan Assets at End of Year	6,141	3,937	7	-
Funded Status at End of Year	\$ (5,303)	\$ (6,548)	\$ (1,136)	\$ (1,194)

At December 31, 2009, UNS Gas' proportionate share of the pension plan's funded status is approximately 55%.

The following table provides the components of UES' regulatory assets that have not been recognized as components of periodic benefit cost as of December 31, 2009:

	Pension Benefits	Other Postretirement Benefits
	-Thousands of Dollars-	
Net Loss	\$ 2,029	\$ 240
Prior Service Cost (Benefit)	1,744	(33)

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

The accumulated benefit obligation for the UES defined benefit pension plan was \$8.8 million at December 31, 2009 and \$6.8 million at December 31, 2008. At December 31, 2009 and 2008, the UES defined benefit pension plan had accumulated benefit obligations in excess of plan assets.

	December 31,	
	2009	2008
	-Thousands of Dollars-	
Projected Benefit Obligation at End of Year	\$ 11,444	\$ 10,485
Accumulated Benefit Obligation at End of Year	8,797	6,760
Fair Value of Plan Assets at End of Year	6,141	3,937

As of December 31 the components of UES' net periodic benefit costs are as follows:

	Pension Benefits		Other Postretirement Benefits	
	2009	2008	2009	2008
	-Thousands of Dollars-			
Components of Net Periodic Cost				
Service Cost	\$1,101	\$ 917	\$ -	\$ -
Interest Cost	651	501	74	71
Expected Return on Plan Assets	(356)	(430)	-	-
Prior Service Cost Amortization	258	258	(3)	(3)
Recognized Actuarial (Gain) Loss	176	(19)	8	-
Net Periodic Benefit Cost	\$1,830	\$1,227	\$ 79	\$ 68

In 2009, UNS Gas recognized 54% of total net periodic pension benefit costs and 47% of other postretirement benefit costs based on relative employee participation.

A portion of the net periodic benefit cost was capitalized as a cost of construction and the remainder was included in Other Operating and Maintenance costs.

As of December 31 the amounts recognized by UES as regulatory assets or in AOCI are as follows:

	Pension Benefits	
	2009	2008
	-Thousands of Dollars-	
Changes in Plan Assets and Benefit Obligations Recognized as Regulatory Asset		
Current Year Actuarial (Gain) Loss	\$ (1,053)	\$ 4,214
Amortization of Actuarial Gain (Loss)	(176)	19
Prior Service (Cost) Amortization	(258)	(258)
Measurement Plan Change	-	(20)
Total Recognized as Regulatory Asset	\$ (1,487)	\$ 3,955

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

	Other Postretirement Benefits		
	Regulatory Asset	Regulatory Asset	AOCI
	2009	2008	
	-Thousands of Dollars-		
Changes in Benefit Obligation Recognized as Regulatory Assets or in AOCI			
Current Year Actuarial (Gain) Loss	\$ 33	\$ 277	\$ -
Amortization of Actuarial Gain (Loss)	(8)	-	-
Prior Service (Cost) Amortization	3	-	3
Reclassification from AOCI to Regulatory Asset	-	(99)	99
Total Recognized as Regulatory Assets or in AOCI	\$ 28	\$ 178	\$ 102

For the pension plan, we amortize prior service costs on a straight-line basis over the average remaining service period of employees expected to receive benefits under the plan. UES will amortize \$0.3 million of prior service cost and \$0.2 million of net loss from regulatory assets into net periodic benefit cost in 2010. The estimated net loss and prior service benefit for the defined benefit postretirement plans that will be amortized from regulatory assets into net periodic benefit cost in 2010 are less than \$0.1 million, respectively.

Weighted-Average Assumptions Used to Determine Benefit Obligations as of the Measurement Date,

	Pension Benefits		Other Postretirement Benefits	
	2009	2008	2009	2008
Discount Rate	6.3%	6.3%	6.0%	6.5%
Rate of Compensation Increase	3.00 – 4.00%	3.00 – 4.00%	N/A	N/A

Weighted-Average Assumptions Used to Determine Net Periodic Benefit Costs for Period Ended December 31,

	Pension Benefits		Other Postretirement Benefits	
	2009	2008	2009	2008
Discount Rate	6.3%	6.8%	6.5%	6.5%
Rate of Compensation Increase	3.00 – 4.00%	3.00 – 4.00%	-	-
Expected Return on Plan Assets	8.0%	7.75%	-	-

Net periodic benefit cost is subject to various assumptions and determinations, such as the discount rate, the rate of compensation increase, and the expected return on plan assets. UES uses a combination of sources in selecting the expected long-term rate-of-return-on-assets assumption, including an investment return model. The model used provides a “best estimate” range over 20 years from the 25th percentile to the 75th percentile. The model used as a guideline for selecting the overall rate-of-return-on-assets assumption is based on forward looking return expectations only. The above method is used for all asset classes.

Changes that may arise over time with regard to these assumptions and determinations will change amounts recorded in the future as net periodic benefit cost.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

	2009	December 31, 2008
Assumed Health Care Cost Trend Rates		
Health Care Cost Trend Rate Assumed for Next Year	7.9%	7.5%
Ultimate Health Care Cost Trend Rate Assumed	4.5%	5.0%
Year that the Rate Reaches the Ultimate Trend Rate	2027	2017

A one-percentage-point change in assumed health care cost trend rates would have an impact of less than \$0.1 million on UES' benefit obligation on the December 31, 2009 amounts reported.

Pension Plan Assets

UES calculates the market-related value of plan assets using the fair value of plan assets on the measurement date. The pension plan asset allocations by asset category are as follows:

	Plan Assets	
	December 31,	
	2009	2008
Asset Category		
Equity Securities	56%	67%
Fixed Income Securities	33%	31%
Real Estate	11%	-
Cash	-	2%
Total	100%	100%

The policy for the UES pension plan is to provide exposures to equity and debt securities by investing in a balanced fund.

Fair Value Measurements of Pension Assets				
December 31, 2009				
-Thousands of Dollars-				
Asset Category	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Cash	\$ 2	\$ -	\$ -	\$ 2
Equity Securities:				
U.S. Large Cap	-	1,729	-	1,729
U.S. Small Cap	-	340	-	340
Non-U.S.	-	1,341	-	1,341
Fixed Income	-	2,049	-	2,049
Real Estate	-	680	-	680
Total	\$ 2	\$ 6,139	\$ -	\$ 6,141

Level 1 cash equivalents are based on observable market prices and are comprised of the fair value of commercial paper, money market funds, and certificates of deposit.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

Level 2 investments comprise amounts held in co-mingled equity, US bond and real estate funds. Valuations are based on active market quoted prices for assets held by each respective fund.

Pension Plan Investments

Investment Goals

Strategic asset allocation is the principal method for achieving the plan's investment objective, while maintaining an appropriate level of risk. We will consider the projected impact on benefit security of any proposed changes to the current asset allocation policy. The expected long-term returns and implications for funding will be reviewed in selecting policies to ensure that current asset pools are projected to be adequate to meet the expected liabilities of the Plan. We expect to use asset allocation policies weighted most heavily to equity and fixed income funds, while maintaining some exposure to real estate and opportunistic funds. Within the fixed income allocation, long-duration funds may be used to partially hedge interest rate risk. The plan seeks to provide returns in excess of a portfolio benchmark.

Risk Management

We recognize the difficulty of achieving investment objectives in light of the uncertainties and complexities of the investment markets. We also recognize some risk must be assumed to achieve a Plan's long-term investment objectives. In establishing risk tolerances, the following factors affecting risk tolerance and risk objectives will be considered: 1) Plan status; 2) UES' financial status and profitability; 3) Plan features; and 4) workforce characteristics. We have determined that the Plan can tolerate some interim fluctuations in market value and rates of return in order to achieve long-term objectives. We track the plan's portfolio relative to the benchmark through quarterly investment reviews. The reviews consist of a performance and risk assessment of all investment managers and on the portfolio as a whole. Investment managers for the plan may use derivative financial instruments for risk management purposes or as part of their investment strategy. Currency hedges have also been used for defensive purposes.

Relationship between Plan Assets and Benefit Obligations

The overall health of the Plan will be monitored by comparing the value of Plan obligations (both Accumulated Benefit Obligation and Projected Benefit Obligation) against the market value of assets and tracking the changes in each. The frequency of this monitoring will depend on the availability of Plan data, but will be no less frequent than annually via annual actuarial valuation.

The current target allocation percentages for the major categories or plan assets follow. There is a range of +/- 2% of the target allocation before the fund will be automatically rebalanced.

	UES Plan %
Fixed Income	33.4%
U.S. Large Cap	27.8%
Non-US Developed	16.7%
Real Estate	11.1%
U. S. Small Cap	5.5%
Non-US Emerging	5.5%
Total	100.0%

Pension Fund Descriptions

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

All of the funds are based on a manager-of-managers approach. This approach is predicated on a research-driven evaluation of outside money-managers by an independent investment consultant employed by The Plan. The investment consultant is responsible for allocating capital to numerous fund managers based on The Plan's desired asset allocation. For example, there might be 10 different fund managers who are allocated capital under The Plan's Fixed Income allocation by the investment consultant. It is in this manner the investment consultant serves as The Plan's "manager-of-managers".

Estimated Future Benefit Payments

As of December 31 the following benefit payments, which reflect future service, as appropriate, are expected to be paid by UES:

	Pension Benefits	Other Postretirement Benefits
	- Thousands of Dollars -	
2010	\$ 362	\$ 122
2011	673	121
2012	789	118
2013	791	116
2014	906	113
Years 2015-2019	6,839	496

DEFINED CONTRIBUTION PLAN

UNS Gas offers a defined contribution savings plan to all eligible employees. The Internal Revenue Code identifies the plan as a qualified 401(k) plan. Participants direct the investment of contributions to certain funds in their account. UNS Gas matches part of a participant's contributions to the plan. UNS Gas made matching contributions of less than \$0.3 million in each of 2009 and 2008.

NOTE 9. FAIR VALUE MEASUREMENTS

The following tables set forth, by level within the fair value hierarchy, UNS Gas' financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2009 and December 31, 2008. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
December 31, 2009				
- Thousands of Dollars -				
Assets				
Cash Equivalents ⁽¹⁾	\$ 25,559	\$ -	\$ -	\$ 25,559
Collateral Posted ⁽²⁾	-	1,750	-	1,750
Energy Contracts ⁽³⁾	3	274	-	277
Total Assets	25,562	2,024	-	27,586
Liabilities				
Energy Contracts ⁽³⁾	(2)	(7,677)	-	(7,679)
Total Liabilities	(2)	(7,677)	-	(7,679)
Net Total Assets and (Liabilities)	\$ 25,560	\$ (5,653)	\$ -	\$ 19,907

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
December 31, 2008				
- Thousands of Dollars -				
Assets				
Cash Equivalents ⁽¹⁾	\$ 1,070	\$ -	\$ -	\$ 1,070
Collateral Posted ⁽²⁾	-	7,500	-	7,500
Energy Contracts ⁽³⁾	-	358	-	358
Total Assets	1,070	7,858	-	8,928
Liabilities				
Energy Contracts ⁽³⁾	-	(13,529)	-	(13,529)
Total Liabilities	-	(13,529)	-	(13,529)
Net Total Assets and (Liabilities)	\$ 1,070	\$ (5,671)	\$ -	\$ (4,601)

(1) Cash Equivalents are based on observable market prices and are comprised of the fair value of money market funds and certificates of deposit.

(2) Collateral provided for energy contracts with counterparties to reduce credit risk exposure.

(3) Energy contracts include gasoline/diesel swap agreements (Level 1) and natural gas swap agreements (Level 2) entered into to reduce exposure to energy price risk. The valuation techniques are described below.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

Energy Contracts

UNS Gas primarily applies the market approach for recurring fair value measurements and endeavors to utilize the best available information. Where observable inputs are available for substantially the full term of the asset or liability, such as gas swap derivatives valued using New York Mercantile Exchange (NYMEX) pricing, adjusted for basin differences, the instrument is categorized in Level 2.

For gas prices, UNS Gas obtains quotes from brokers, major market participants, exchanges or industry publications as well as its own price experience from active transactions in the market. UNS Gas primarily uses one set of quotations for gas, and then uses the other sources as validation of those prices. UNS Gas applies certain management assumptions to value energy contracts. These assumptions include the impact of counterparty credit risk using current and historical default and recovery rates as well as our own credit risk using credit default swap data. UNS Gas reviews these assumptions on a quarterly basis.

UNS Gas' assessment of the significance of a particular input to the fair value measurements requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels.

NOTE 10. COMMON STOCK EQUITY

DIVIDEND RESTRICTIONS

The terms of UNS Gas' senior unsecured note agreements contain dividend restrictions. See Note 5. UNS Gas made no dividend payments to UES in 2009 or in 2008.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

NOTE 11. SUPPLEMENTAL CASH FLOW INFORMATION

A reconciliation of net income to net cash flows from operating activities follows:

	Years Ended December 31,	
	2009	2008
	-Thousand of Dollars-	
Net Income	\$ 7,367	\$ 8,538
Adjustments to Reconcile Net Income to Net Cash Flows		
Depreciation and Amortization Expense	7,303	6,869
Depreciation Recorded to Other Operations & Maintenance Expense	813	861
Amortization of Deferred Debt-Related Costs Included in Interest Expense	165	167
Provision for Bad Debts	679	850
Deferred Income Taxes	5,032	3,757
Pension and Postretirement Expense	1,031	687
Pension and Postretirement Funding	(852)	(690)
Over Recovered Purchased Energy Costs	5,367	(8,230)
Changes in Assets and Liabilities which Provided (Used)		
Cash Exclusive of Changes Shown Separately		
Accounts Receivable	2,695	3,172
Materials and Supplies Inventory	(178)	(97)
Cash Collateral Posted for Energy Contracts	5,750	(7,500)
Income Tax Receivable/Payable	(87)	535
Accounts Payable	1,308	(4,388)
Interest Accrued	7	(84)
Taxes Accrued	(307)	237
Other	862	(1,837)
Net Cash Flows – Operating Activities	\$36,955	\$ 2,847

NOTE 12. ACCOUNTING FOR DERIVATIVE INSTRUMENTS, TRADING ACTIVITIES AND HEDGING ACTIVITIES

See Note 2 for description of our related accounting policies.

Regulatory Treatment of Commodity Derivatives

UNS Gas reports unrealized gains and losses on energy contracts that are recoverable through the PGA on the balance sheet as a regulatory asset or a regulatory liability rather than as a component of AOCI or in the income statement. UNS Gas recorded decreases to regulatory balances of \$5.8 million and increases of \$13.2 million in 2009 and 2008, respectively. Realized gains and losses on settled gas swaps are fully recovered through the PGA. In 2009 and 2008, UNS Gas had realized losses of \$10.4 million and \$4.1 million, respectively.

At December 31, 2009, UNS Gas had contracts that will settle through the fourth quarter of 2012.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (continued)

Other Commodity Derivatives

UNS Gas recorded unrealized gains/losses on Negotiated Sales Programs (NSP) sales contracts in Gas Revenue and NSP purchase contracts in Purchased Energy of \$0.3 million and \$0.2 million in 2009 and 2008, respectively.

Derivative Volumes

At December 31, 2009, UNS Gas had gas contracts totaling 5,139 GBtu which were accounted for as derivatives.

Credit Risk Adjustment

When the fair value of our derivative contracts are reflected as an asset, the counterparty owes us and this creates credit risk. We minimize our credit risk by (1) entering into transactions with high-quality counterparties; (2) limiting our exposure to each counterparty; (3) monitoring the financial condition of the counterparties; and (4) requiring collateral in accordance with the counterparty master agreements. Using a combination of market credit default swap data and historical recovery rates for subordinated bonds, we consider the impact of counterparty credit worthiness in determining the fair value of our derivatives. At December 31, 2009, and December 31, 2008, the impact of counterparty credit risk on the fair value of derivative asset contracts was less than \$0.5 million.

We also consider the impact of our own credit risk on instruments that are in a net liability position. We calculate the impact using market credit default swap data, after deducting collateral posted, and allocate the credit risk adjustment to all individual contracts in a net liability position. At December 31, 2009, and December 31, 2008, the impact of our own credit risk was less than \$0.5 million.

Concentration of Credit Risk

The use of contractual arrangements to manage the risks associated with changes in energy commodity prices creates credit risk exposure resulting from the possibility of nonperformance by counterparties pursuant to the terms of their contractual obligations. UNS Gas enters into contracts for the physical delivery of gas which contain remedies in the event of non-performance by the supply counterparties. In addition, volatile energy prices can create significant credit exposure from energy market receivables and mark-to-market valuations.

UNS Gas has contractual agreements for its energy procurement and hedging activities that contain certain provisions that require it to post collateral under certain circumstances. These circumstances include credit rating downgrades, or a failure to meet certain financial ratios. In the event that such credit events were to occur, UNS Gas would have to provide certain credit enhancements in the form of cash or letters of credit to fully collateralize its exposure to these counterparties.

The following table shows the sum of the fair value of all derivative instruments along with net payable position under contracts with credit-risk-related contingent features that are in a net liability position at December 31, 2009. It also shows cash collateral and letters of credit posted, and additional collateral to be posted if credit-risk related contingent features were triggered.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (concluded)

	UNS Gas
	December 31, 2009
	-Thousands of Dollars-
Net Liability Position	\$ 25,329
Cash Collateral Posted	1,750
Letters of Credit	-
Additional Collateral to Post if Contingent Features Triggered	23,579

At December 31, 2009, UNS Gas had immaterial exposure to other counterparties.